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Domestic Bank Regulation in a Global Environment - A Comparative Dialogue

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Domestic Bank Regulation in a Global Environment – A Comparative Dialogue

I. INTRODUCTION

On November 14, 2012, the Center for Banking and Finance at the University of North Carolina School of Law hosted a dialogue on domestic bank regulation in a global environment at The Metropolitan Club of New York. This event preceded The Clearing House's Annual Meeting and Business Conference.¹ The Clearing House also provided generous financial support for the debate. Biographical information about the moderators, Lissa Broome and Michael Helfer, and the panelists is set forth before the transcript of the dialogue begins.

Lissa Broome is the Wells Fargo Professor of Banking at the University of North Carolina School of Law and also the director of the school's Center for Banking and Finance.

Michael Helfer became vice-chairman of Citi in June 2012 after having served as its general counsel and corporate secretary for almost ten years. Prior to joining Citigroup, Mr. Helfer was President of Strategic Investments and Chief Strategic Officer of Nationwide Insurance. He was formerly a partner at the law firm of Wilmer, Cutler & Pickering.

Cyrus Amir-Mokri is the Assistant Secretary for Financial Institutions at the U.S. Treasury Department. He recently served as Senior Counsel to the Chairman of the Commodity Futures Trading Commission (CFTC), where he was the agency's deputy representative to the Financial Stability Oversight Council (FSOC). Prior to joining

1. The Clearing House is the oldest banking association and payments company in the United States, having been established in 1853. It is owned by the world's largest commercial banks. The Clearing House Payments Company L.L.C. provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated-clearinghouse, funds-transfer, and check-image payments made in the U.S. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing the interests of its owner banks on a variety of important banking issues.

the CFTC, Mr. Amir-Mokri was a partner at Skadden, Arps, Slate, Meagher & Flom LLP.

Chris Brummer is a Professor of Law at Georgetown University Law Center, B. Gray Fellow for Growth and Finance at the Atlantic Council and senior fellow at the Milken Institute. He previously taught at Vanderbilt Law School and has served as a visiting professor at the universities of Basel, Heidelberg, and the London School of Economics. He practiced law in New York City and London with the law firm Cravath, Swaine & Moore. His book, *Soft Law and the Global Financial System: Rule Making in the 21st Century*, was published this year by Cambridge University Press.

Robert Hockett is a Professor of Law at Cornell Law School, Consulting Counsel at the International Monetary Fund (IMF), recent Resident Consultant at the Federal Reserve Bank of New York, and fellow at The Century Foundation. His principal areas of expertise are organizational, financial, and monetary law and economics, particularly as these relate to distributive justice and economic “globalization.” Prior to entering full-time teaching, Professor Hockett worked for the IMF and clerked on the U.S. Court of Appeals for the 10th Circuit. While on sabbatical in 2012-13 he is again working with the IMF.

Nick O’Neill is a partner at Clifford Chance LLP. He is now in the New York office of the firm and works in the firm’s international regulatory practice.

II. DOMESTIC INSTITUTIONS AND INTERNATIONAL STANDARD SETTERS

Broome: Before we get into our substantive dialogue – this is the third in the New York Lecture Series sponsored by our friends at The Clearing House. Let me give special thanks to Jim Aramanda, Paul Saltzman, and Dan McCardell for their help with this program and support throughout the years. We also appreciate the support of UNC School of Law Dean Jack Boger.

The topic of this year’s program is domestic bank regulation in a global environment—a comparative dialogue. We have divided our discussion today into roughly four segments and the first segment deals with domestic institutions and international standards like Basel III, just naming one. We have a number of different perspectives represented on

this panel—regulatory, industry, and academic—so let me ask you, Cyrus, to describe how domestic institutions are affected by international standard setters.

Amir-Mokri: The way to think about domestic institutions or any institution in any country and international standard setters is to think about what international standard setting does. The first thing it does is it establishes, or is supposed to establish, a level playing field. That is, all must adhere to the same standard and all are going to be judged by the same set of criteria. These standards include Basel. In our world of financial services there is not only the Basel Committee on Banking Supervision but IOSCO,² CPSS,³ and the world of insurance has the IAIS.⁴

The world is very interconnected. It is a global financial system, especially at the institutional level. It's important to have common rules of the road and that is particularly important for our global financial institutions, whether U.S.-based or foreign-based. A uniform set of standards across the important jurisdictions is critical for, at the very least, a level playing field and to ensure that we are respecting the rule of law.

When you reflect back on the 2008 crisis I think there is another very important dimension to it as well, and that is the commonality of the standards is important for a signaling purpose. The standards should be robust so that in terms of financial stability and certainty, whether it is from the point of view of the retail customer, the point of view of the investor in a financial institution, or the point of view of the counterparty to a financial institution, that at least they have the confidence that they know who they are dealing with in a particular jurisdiction meets the standards that the regulators and the financial sector generally would like to adhere to. This gives everyone confidence and, as you know, the financial sector is all about confidence. So I think these two things are crucial: first, the rule of law certainty with a level competitive playing field, and then second, confidence. I think these are two very important things to keep in mind when you think about standard setting.

2. International Organization of Securities Commissions.

3. Committee on Payment and Settlement Systems.

4. International Association of Insurance Supervisors.

The last thing I'll say about standard setting in domestic financial institutions is I mentioned our global financial institutions and the certainty that they would have if they went into another jurisdiction in terms of dealing with the laws of that jurisdiction. There is the flip side of it—institutions from foreign jurisdictions coming into the U.S. Some of our domestic institutions who don't have a foreign presence can at least have that certainty that the foreign institutions are dealing with similar circumstances. So you don't have to just be a global player for international standards to matter to you in a positive way.

International standards are, of course, just standards. They have to be applied in each jurisdiction and each jurisdiction has its own particular history. There are going to be times when variances from the international standards, or at least interpretations, are going to be particular to the particular structure that you have. But again that's a balance. It's a tight balance between adhering to international standards and having sensible local variations when it makes sense. The variations need to be transparent so we, the domestic institutions, have the confidence that there isn't cheating going on in another jurisdiction. So that's how I think about international standards.

Broome: Chris, do you have anything to add?

Brummer: I think when one talks about international standards it is important to understand the system in which international standards operate and it is important to understand exactly what international standards are. International standards are really different when one thinks about other more traditional areas of international economic law like the international trade space. When you talk about the international regulatory architecture it's a very fragmented world.

Here is a quick overview. The big picture is that you have agenda setting that's effectively done by the G-20.⁵ Formerly you had the G-7, but in 2008, the G-20 became the primary agenda setting body with heads of state working alongside finance ministers and central bankers. Agenda setting is then operationalized in broad terms through an organization called the Financial Stability Board, which serves as a

5. The Group of Twenty Finance Ministers and Central Bank Governors.

more technocratic clearinghouse and counterpart to the G-20.

Alongside the agenda setters, you have the standard setting bodies themselves by sector —the Basel Committee for banking, IOSCO for securities regulation, IAIS for insurance, and then you have these specialist organizations for accounting like IASB,⁶ and CPSS. Then you have the implantation by the regulators themselves who participate in each one of those forums as well as the monitoring that's done both through the IMF⁷ and the World Bank and then through various peer review structures. What's important to understand when you look at this very fragmented system is that, as fragmented as it is, it's been sort of vertically integrated since the 2008 crisis with the G-20 taking a lead with regards to financial regulation.

Many of these organizations came of age in the wake of the Asia financial crisis, but they didn't necessarily even talk to one another in a very comprehensive or robust way and so you had lots of gaps. What's interesting about this—besides the fact that you have a highly fragmented regulatory architecture which gives a lot of people headaches because we usually think of regulations as emanating from the domestic level but instead we have a highly fragmented international space—is that the rules themselves are not rules as we lawyers typically expect. They are not hard law. They are not formal international obligations that you see when one talks about the WTO.⁸ Indeed, the forums that generate the international rules are themselves not international organizations. They are not founded by articles of agreement like the IMF or the GATTs⁹ or something similar to the WTO¹⁰ or the EU¹¹ with treaties. Instead, they are highly informal, highly flexible, and the rules that they generate can be considered soft law. Because they are not generally binding as a matter of international law, there are questions that naturally arise by practitioners, specialists, and academics as to what is the meaning of these rules. How useful are they, particularly when lots of resources are devoted towards creating a

6. International Accounting Standards Board.

7. International Monetary Fund.

8. World Trade Forum.

9. General Agreement on Tariffs and Trade.

10. World Trade Organization.

11. European Union.

level playing field and more transparency with regards to the legal rules that oversee financial institutions and the general trading environment? A lot of the discussion that we will hear later today ultimately questions just how effective are non-binding, informal rules and what is the relationship between national regulators and these non-binding international rules.

Despite their nonbinding nature, there are lots of incentives that can be generated to incentivize regulators to hew closely to those rules and for institutions to comply even in the absence of overt regulation by their own national regulatory supervisor. At the same time, the level of compliance is going to differ depending on the issue area and backdrop against which rules are promulgated. The commitment to creating a robust playing field will often depend on lots of technicalities, but among those technicalities the institutional architecture and framework in which those soft law nonbinding rules are generated is very important for financial institutions as well as lawyers to understand that regulatory environment.

Broome: Michael, I wanted to ask you how these international standards impact an institution with the scope and size of operations of Citi?

Helper: I'm tempted simply to say, "Every day, in every way." These rules affect what we do and how we do it and what activities we conduct and what kinds of transactions we will agree to participate in. International standards in general, for the reasons that have been laid out, are a desirable thing for an institution that deals in a hundred countries. At the same time, we shouldn't be unrealistic about the problems that they don't solve because they don't solve most problems. Host country regulators, host country governments, host country legislators, host country politicians, and host country press will all have their own views about what foreign banks ought to be allowed to do in the host country. They operate and can operate effectively on some mega issues like Basel III and bank capital but they don't solve problems on a day-to-day basis where you operate under the rules of the host country or you don't operate at all.

The second thing about international standards is they take a

long time to develop. That may be a good thing in some instances and may be a bad thing in other instances. History teaches, I think, that enforcement of international standards varies dramatically among countries and regulators. The quickest and easiest example of this is the discussion about risk weights applied to the balance sheets of different institutions, whose balance sheets at least on a GAAP or international standard basis look pretty darned similar and wind up with dramatically different risk-weighted assets, the denominator in the capital ratio. We can all agree on what the numerator is, or we can get close enough on what the numerator is. But you can take somebody's actual 2 % capital and make it look like 10% capital pretty easily by adjusting the denominator through the risk-adjusted assets. Not that anyone would actually do that, but it could raise some questions.

The other question that I just note because it is coming up as a subject of congressional hearings is the application of the Basel III standards to community banks in the United States. That is a very controversial, highly politicized issue right now so it is one thing to apply these international standards to international banks or banks that could be significant even in domestic economies and yet may be a different thing to apply them to much smaller institutions.

Broome: Nick, as an advisor to financial institutions, what is your perspective on these international standards?

O'Neill: Well, I agree with everybody that setting a level playing field internationally is something which organizations carrying on business internationally wish to see preserved. The devil, though, as everybody is saying, is really in the details of implementation and enforcement. There are many examples of inconsistency. Many of you will have seen the Basel III consistency assessment report that came out in October 2012 which showed that there isn't a great deal of consistency in international implementation. Likewise with many of the changes that came out of the financial crisis such as the G-20 recommendations, where implementation is really all over the map.

A good example of such inconsistency might be OTC derivative clearing. There is a clear impetus post-financial crisis to make that market safer and more secure. If you look at how the two major

regional blocks that have led the way in this area are dealing with this, the U.S. and the EU, they are implementing quite differently, leading to huge logistical challenges for organizations who are part of a global market and who are going to have to try and work out how to effectively segment that industry between two geographic blocks. There is a global standard that all regularly traded liquid OTC derivatives are going to be cleared, but the practical challenges of implementing very different practical rules are proving to be very, very significant to those organizations in that market. In terms of implementation challenges, this gives rise to significant costs. People are having to look again at their structures to work out whether they are actually set up in a way that can really comply with those standards as they apply in different geographies.

The EU is a good example of how long it can take and how difficult it is to achieve true harmonization. I have practiced in London for many years. My practice has been advising clients dealing with EU regulations that developed through the single market during the 90s and past the millennium. I think there we saw a real challenge of a number of jurisdictions that are bound together by treaties and that are trying to formulate a single market with a single set of harmonized standards across that financial market. The truth of the matter is that this only really started to work in the sense of actually achieving harmonized standards once the EU achieved full harmonized implementation. So the standards were fine but then you got a lot of gold plating as Michael Helfer has noted. You got a lot of interpretation of what those rules meant.

It was only once you got true harmonization of implementation that it began to work in practice, and you could actually predict that a rule would be interpreted and applied similarly across the EU. So that has taken a long period of time and has developed through treaty, not as Chris Brummer was noting in relation to international standards through soft law. That is hard treaty and still it has twenty-odd years to develop what is close to harmonized implementation. By comparison, many of these international standards are a long way away from truly harmonized implementation and application.

Broome: Bob, you get the last word on this topic.

Hockett: Great. Just two quick thoughts. First, I'm always struck by the way in which many aspects of financial regulation can be readily characterized as solutions to classic collective action problems. A collective action problem is a situation in which actions that, when taken by individual actors, are individually rational can nevertheless aggregate, when taken by a multitude of people, into collectively irrational outcomes. An arms race is a classic case in point. If you are in the midst of an arms race and your opponent is stockpiling weapons, it is in your interest to do so as well. Otherwise, you are sort of outcompeted. That's of course why few, if any, people ever advocate unilateral disarmament. On the other hand, while you and your opponent in the race are both locked in that death struggle, you are wasting resources enormously, so it is in your best interest to come up with some way to limit arms on both sides.

Now, if you think along these lines in connection with financial regulation, one way of looking at, say, capital regulation is as itself a solution to an arms race sort of situation. So basically it is in the interest of each individual bank to hold as little buffer capital as possible because it is stale and unprofitable when it is just sitting there, whereas if you can lend it out or invest it you're going to earn returns on it. Of course all of those that you are competing with, moreover, are thinking similarly; so that if you individually hold more buffer capital than your competitors are holding, you are putting yourself at a disadvantage relative to them and in that sense you're unilaterally disarming in an arms race. On the other hand, everyone's accordingly racing to the "capital bottom" imperils the financial system and those who take part in it. So it is in the interest of you and of all your competitors—your fellow banks—to have something like a SALT¹² or START¹³ treaty, some kind of a "capital arms control agreement." And that's one way of looking at domestic capital regulation.

Now if you think of capital regulation at the global level rather than at the domestic level, the situation is structurally identical. In

12. Strategic Arms Limitation Talks, U.S.-U.S.S.R., Nov. 21, 1972, 23 U.S.T. 3736.

13. Treaty on the Reduction and Limitation of Strategic Offensive Arms, July 31, 1991, U.S.-U.S.S.R., S. TREATY DOC. NO. 102-20 (1991).

effect it is in the interest of each nation to see all nations' principal financial institutions holding a certain amount of buffer capital. For if they are not—that is, if everybody is just competing to the point where they simply lend out their buffer capital to the point where there *is* no buffer capital—then you foment systemic instability throughout the global financial economy just as the absence of domestic capital regulation does within a national economy. So it is in the interest of all of the nations, just as it is in the interest of all the financial institutions within those nations, to have some kind of an arms control agreement, so to speak—a common capital standard at the global level. For the same reason it is in the interest of the banking institutions within domestic jurisdictions to have uniform sets of standards among banks within those jurisdictions. I think one helpful way of looking at the Basel process, as well as most if not all other global regulatory convergence projects, is as essentially a kind of carrying over, to the global case, the same logic of collective action problem solving as applies to the domestic case. It is necessary to do this, in turn, because the global financial markets are now so fully integrated.

The second observation I think worth making here has to do with the way soft law, as I understand it, seems to work. Soft law works partly through the significant degree of regulatory discretion that is conferred upon domestic financial regulators from jurisdiction to jurisdiction—at least within the major financial jurisdictions. U.S. regulators, for example, of course have a great deal of room in which to maneuver in applying what generally are quite broadly stated statutory mandates or standards. My understanding is that the story is much the same in our peer jurisdictions. What that means in turn is that when regulators can come together in some singular forum—for example, on the Basel Committee or over at the IMF or within the G-20 or some other forum—and then agree at least roughly to some common set of standards, they've got a great deal of discretion when they get back home to implement those very standards. What that means is that global stability rides significantly upon the capacity of those regulators to agree and to see things similarly.

One thing I'm struck by, and this might be a kind of rose-tinted glasses problem on my part, is the degree to which domestic financial regulators *do* seem often to see things similarly irrespective of what

jurisdictions they come from. In my experience, American financial regulators don't seem to be acting as champions of American institutions while European regulators are acting as champions for European institutions. Hence you don't typically see them bickering, or trying to give their institutions a leg up on others', at Basel or at the IMF or in other such fora. They seem by and large actually to share a sort of good faith commitment to the stability of the global financial system as a whole, and to come at the matter of domestic regulatory coordination in a spirit of good faith collaboration. Maybe someone will have counter-instances of that but this is how things generally strike me in my own experience. In so far as that is the case I think it is very good news, because these regulators do indeed subsequently wield much discretion in their home jurisdictions in implementing the particular standards upon which they agree in these international forums.

Brummer: I do think there are some counter-examples of silent participations with German and French banks and the like. Regulators tend to understand their markets pretty well and they want to be at least advocates for their institutions.

III. POST-CRISIS REGULATORY APPROACHES OF HOME COUNTRY REGULATORS

Helper: The U.S. is obviously not unilaterally disarming here. Chris, how does Dodd-Frank¹⁴ affect domestic financial institutions with respect to their cross-border operations?

Brummer: I think that Dodd-Frank is interesting. I think that it is important to recognize that there was an agenda that took shape in the Washington and London Summits of the G-20. Among the different agenda items were some of the things that the Dodd-Frank Act tries to address now. I can make the very depressing observation that as much as we may complain about Basel III and capital standards, believe it or

14. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified in scattered sections of the U.S. Code).

not the international regulatory process has moved from the lower hanging fruit towards the more and more difficult things. Basel and capital standards were conceptually considered one of the easier things. Moving then on to derivatives, OTC trading, then moving a little bit further afield to say cross-border bank resolution, which is the nirvana of international financial regulation.

When you look at a lot of the things that the Dodd-Frank Act is trying to address, they are more the intermediary stage of the international standard setting process and in particular the implementation process. Obviously, there are two big questions when one thinks about Dodd-Frank—the Volcker Rule¹⁵ in Title VI and the derivatives issue in Title VII. The Volcker Rule was not part of the original G-20 agenda so that's something to keep in mind. Before we jump into what the Volcker Rule means from the question of international standard setting, it is useful to note that when look at the line items of the G-20, the Volcker rule was intentionally not brought up as a full-fledged agenda item. That's why we have differences right now in the Liikanen Report,¹⁶ Vickers,¹⁷ and the Volcker Rule here in the United States.

Title VII, on the other hand, is an attempt to implement the broader standards of the G-20 agenda with regard to derivatives. The tack taken particularly with OTC derivatives, even though sponsored by IOSCO and the Basel committees, has been much more of a transatlantic process of less than effective dialogue between the European and American authorities. We moved faster, at least with regards to the Dodd-Frank Act and Title VI, than the Europeans, although obviously in their legislation they have caught up a good deal. But the dual tracking of the Europeans and the United States has led to a variety of inconsistencies because even though they are working through the international standard setting process of the G-20, they are actually adopting old school methods of international financial

15. 12 U.S.C. § 1851 (Supp. IV 2010).

16. High-level Expert Group on Reforming the Structure of the EU Banking Sector (Oct. 2, 2012), *available at* http://www.ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf.

17. The Independent Commission on Banking: The Vickers Report (Sep. 12, 2011), *available at* www.ecgi.org/documents/icb_final_report_12sep2011.pdf.

regulation which is trying to in some ways project your own policy preferences via the regulation of your own domestic markets. Simply put, if you raise your standards high enough, or if you require certain kinds of actions be taken by foreign market participants, you can sometimes export your foreign policy preferences abroad.

The interesting question arises when both decide to leverage their domestic markets and their infrastructure in a way to project their policy preferences, what happens? What happens when you have dual reporting requirements? What happens when you have dual clearing requirements? To what degree do duplicative regulatory requirements lead not only to costs but also to inconsistencies that themselves are then impossible for any one market participant to comply with? So if Europe says “X” and the U.S. says “Y” and you can’t do both, what then are you supposed to do?

The even more complicated question is when you have the emerging financial centers in Singapore and Hong Kong that remain relatively quiet but then are looking at the implementation process and are deciding that they do not like certain aspects of it. I try to tell my students all the time that derivatives are to bonds what bonds were to bank loans in terms of the mobility of the transaction. When you have any part of the world that decides not to play along and you have a financial center that ultimately erodes even the tentative commitments that are being made at a transatlantic basis, then you have a problem. So the U.S. adopted a more territorial approach with reporting and clearing requirements in the Volker Rule, which is obviously still under discussion in Europe as well here. They are adopting versions that could have an extraterritorial impact and we will hear that what that means depends in part on what kind of banking union the EU is going to have. The EU nations must figure out for themselves what kind of banking regulation they want to have, but clearly we have to think of mutual recognition programs to bridge the gap for a more efficient regulatory process.

Helper: Cyrus, your views on this?

Amir-Mokri: These are all very important issues. On Dodd-Frank I will say a couple of things in terms of how it deals with

international and cross-border issues. Some of the issues that Dodd-Frank tried to address were truly international in nature. I start with the logic of Title I, which is consolidated supervision. A lot of that grew out of AIG¹⁸ and its London subsidiary, given the nation state-based jurisdictional structure that we have even with global financial institutions. One of the problems that needed to be solved was what do you do with an institution that is multi-jurisdictional. Who has the ultimate accountability for the oversight? That is one way that there is a nexus between cross-border activity, multijurisdictional activity and what Dodd-Frank tries to do.

Someone earlier mentioned the resolution. That is another good example, but it again ties to the same question. Now it is no longer supervision, it is resolution, recovery, liquidation – whichever variant of that applies at that moment. It does implicate important cross-border questions and cooperation between jurisdictions. So that is another nexus Dodd-Frank has with cross-border activity that I think is important.

You also mentioned OTC derivatives. I think it is important to distinguish between situations where you have a domestic market and then someone comes in and participates in that market and the rules of the game are really that jurisdiction's rules of the game. Whether they adhere to an international standard or not is an analytically distinct question, but at least you are subject to those rules. So that is different from standard-setting situations. Then you have situations that ask: when does a jurisdiction's rules have extra-territorial effect? Those are also some important issues that are raised in Title VII.

Whenever you embark on the kind of effort that the international regulators and the G-20 have been trying to do over the last few years the surprising thing shouldn't be that there are differences of viewpoint or that there is not perfect harmony in implementation or that there is going to be debate about who has what detail better. To me, the more amazing thing has been the actual convergence. It is not perfect. Everyone is not on the same page about every detail. To me that's a given. But think about it a couple of years ago. You're absolutely right. The G-20 pronouncements did not have proprietary

18. American International Group, Inc.

trading on the list. Nevertheless, today we have multiple jurisdictions – whether it is the U.K., the EU – maybe not taking the same exact approach that the U.S. Congress took, but the intuition is that there are certain kinds of trading that should be separated from the retail deposit institution. That intuition has grabbed hold in multiple jurisdictions. OTC derivatives—the same. I remember during the Dodd-Frank process, several principles the Congress was considering. One was regulation of the major dealers, then central counter-party clearing, and then there was this other issue of pre-trade transparency and executing trades on a platform. There was convergence not on every detail, but some very major issues in a short period of time. There has been convergence. We can have different opinions on how each of us individually is going to assess those, but it has been remarkable on very, very complex issues in a short period of time.

Michael, I take your point that regulators do not always see eye to eye, but there is a lot to the observation that there has been significant convergence.

Helfer: Let me follow up on that point. We are familiar with the Volcker Rule and the one thousand questions the regulators asked about it. Let me ask Nick to talk about Vickers and the way it approaches what many people say is the same issue.

O'Neill: Vickers is an attempt at ring-fencing in a way that is quite different from Volcker. What Volcker is doing is throwing certain activities that are considered too risky out of institutions. What Vickers is doing is ring-fencing the retail deposit taking business of U.K. banks into a separately ring-fenced entity, and therefore, insulating those activities from riskier activity. I suspect that Vickers will not have too huge of an effect in the U.S. because the U.K. banking market is relatively concentrated among the major U.K. clearers. Vickers also has a rather long time frame to come into effect. We don't even have the legislation yet. We have a proposal. The idea is that it won't fully come into effect until 2019. Essentially what it does is it takes the retail deposit clearing business of the major U.K. clearing banks and requires it to be ring-fenced away from the investment banking and what are considered other riskier activities of U.K. bankers.

There are a couple of other developments in the U.K. which may well have more direct and potentially more immediate effect on the U.S. industry. One is a push from the U.K. regulator for financial institutions to have greater levels of subsidiarization. That is certainly a trend post-financial crisis. They are looking for a lot of entities with big branches in the U.K. to subsidiarize. That is partly because of the concerns they had with the flight of capital out of London and how easy that proved at the time of the financial crisis. The FSA¹⁹ has even pressed EU incorporated entities to subsidiarize within the EU framework. There should not be a requirement to subsidiarize. You should, as an EU institution, be able to freely branch into the U.K. to whatever size you want. The FSA is pushing back against that.

The other thing that I would highlight that is going to have potential impact cross-border from the U.K. is the recent FSA proposal relating to deposit protection and deposit preference schemes. Essentially what the FSA is proposing involves banks that come from a non-EU state which has a deposit protection scheme preferring their own state depositors – an example would be the FDIC scheme here. The proposals in the U.K. are that those banks will also eventually be required to subsidiarize their U.K. deposit-taking activity or offer U.K. depositors equivalent protection to domestic depositors.

All of these ring-fencing efforts—and we'll hear about Liikanen—are an example of where you have regulators looking to achieve broadly the same thing, which is to create a degree of ring-fencing without an international standard. There is clearly a common agenda of some sort here, but nobody really sat down after G-20 and said, "Well let's have some sort of approach to ring-fencing." What you have is different regulators who have gone about it in very different ways and produced really quite different proposals. So, even if not perfect, having some form of attempt to produce an international framework/standard is preferable to not doing so.

Helper: Bob, he set you up nicely to tell us about Liikanen.

Hockett: Yes – thanks very much. So, first, most of the

19. Financial Services Authority.

attention that Liikanen has received thus far has been grabbed by its ring-fencing-like proposal, partly for the reasons we've been talking about. It is another instance in which a kind of global consensus appears to be emerging. In this case, rather informally and not pursuant to any particular forum in which common standards are meant to be arrived at. So you have the Volcker Rule initiatives here in the States, then the Vickers Commission recommendations in the U.K. with a particular form of ring-fencing. Liikanen then presents its own version of the same basic idea – structural segregation between deposit-taking and speculating – for the European Union. In this case the idea would be to take whatever segment of a particular financial institution group that was engaged in what we in the States are calling proprietary trading – whether highly risky speculative trading or less gratuitously risky market making activities – and cordon it off by ensuring that it is taking place within a separate legal entity. The principal, and by now quite familiar, concern is that depositors' funds not be used – and don't find their way – in to financing or funding that kind of activity. An allied concern is to make clear that there is no explicit or implicit government guarantee of the risk-taking entity simply by dint of its loose connection to a deposit-taking entity within some financial group. Whether Liikanen's rendition of this familiar form of segregation will work is almost the same question as to whether U.K.-style or Vicker-style ring-fencing will work. And it of course likewise shares a close family resemblance to the question whether some version of the Volcker Rule might work, although that is of course a tougher question because we don't yet know what the Volcker Rule as articulated and applied is going to be. In any event, that piece of the Liikanen Report has gotten the most attention lately, and that is partly, one supposes, because argumentation over the Volcker Rule has been so conspicuous of late.

But we should take care to note now that Liikanen is not just a ring-fencing proposal. There are at least five distinct proposals made by Liikanen, and what is most striking about the set of five is how many similarities there are between what Liikanen is recommending, what the Financial Crisis Inquiry Commission here in the United States recommended – and Dodd-Frank accordingly includes – and what the Vickers Report has recommended.

The first, flagship proposal under Liikanen is the ring-fencing

proposal separating proprietary activities and deposit-taking activities, making critical use of the corporate form and the legal separation of corporate entities in so doing. We've just covered that.

The second salient proposal found in Liikanen is an orderly liquidation authority type arrangement very much like that which you find in Dodd-Frank. It connects up with the ring-fencing pillar as well, of course, in that the Report recommends that this pillar is necessary for the purposes of arriving at a plausible liquidation, or living will plan, for a European institution. You might even require yet stricter separation between the proprietary risk-taking activities on the one hand and the deposit-taking activities on the other hand, of institutions that are large or interconnected enough as to require living wills. So there is a link up in the sense that you might require even more than the garden variety separation offered by ring-fencing in the case of an institution that you require to compose a plausible living will.

Third, there is a recommendation in Liikanen that institutions rely more heavily on various kinds of so-called "bail-in" lending or debt. There are two reasons. The first is to enhance the capital buffer. For example, in addition to having the equity buffer that ordinary capital regulation would require, you would have more granular prescriptions with respect to the kind of Tier 2 capital or the kinds of debt capitalization or financing of which firms would avail themselves. The second reason for encouraging "bail in" is to make the incentives on the part of those creditors a bit more dramatic. The hope would be that those creditors would prevail upon institutions to be a bit more careful and take less risk. This justification of course relies upon certain assumptions concerning the practical governance of financial institutions that might and might not be plausible in particular jurisdictions. But the point here at present is only to explain Liikanen, not to critique it.

Fourth, there is a grab bag of recommendations that all have analogs in both Dodd-Frank and Vickers. For example, more robust risk-weighting standards—another instance of the perennial effort to head off gaming of capital standards. "Good luck with that," as they say. But at least attention is being drawn to that. In addition, this portion of Liikanen pays special attention to leverage rates, reliance on short-term funding in the financing of longer term investments, and

other forms of systemically dangerous maturity mismatch. These are the same concerns as have been discussed increasingly here in the States under the rubric of so-called “shadow banking.” So that is the fourth recommendation, the sort of “grab bag” of related residual recommendations made by Liikanen.

Fifth and last, something that has not gotten as much attention in U.S. legislation, is the recommendation that corporate governance provisions again be looked at more carefully. It’s kind of Jack Bogle-type stuff. That has not found its way into real robust or significant legislation here in the states, but at least has been part of the conversation. Should we have more powerful and more attentive risk management functions within institutions? Ought there be more power on the part of the boards to prevail on the management not to take excessive risks? This, too, probably falls within the category of “good luck with that.” But in any event, it’s a familiar kind of proposal. We have heard lots of discussion about it here in the States even if it has not found its way into significant or robust legislation. Similar attention has also of course been paid to the same subject over in the U.K.

I’ll just say in closing on Liikanen that, first, again, those five basic proposals are more than just ring-fencing. And second, what’s striking is that not only the ring-fencing, but all five bear striking resemblances to what you find here in the States post-Financial Crisis Inquiry Commission and post-Dodd-Frank, as well as to what you find being discussed in the U.K., especially under the Vickers rubric.

IV. OPERATIONS OF A FINANCIAL INSTITUTION IN MULTIPLE COUNTRIES WITH PRIMARY REGULATION BY THE HOME STATE REGULATOR

Broome: Bob, we’re going to let you go first this time on our third topic.

Hockett: I’d better take a drink.

Broome: Do you think it makes sense for financial institutions that have operations in multiple countries to be primarily regulated by their home state regulator?

Hockett: I suppose I have two thoughts on that. The first is that, in so far as domestic regulators converge on more or less uniform standards pursuant to the processes we have been talking about, it might not make that much difference. But that's a big *if*. As a few of the panelists have mentioned, there is a significant caveat even if you arrive at common, broadly articulated standards. The devil often is in the details, and the "devilish people" are often striving and struggling with respect to those particular details. Moreover, the implementation can indeed sometimes differ from jurisdiction to jurisdiction according to the zeal and effectuality of the regulators and the effectiveness of the legal system more broadly. One should accordingly take the familiar observation that there is convergence underway with the appropriate grain of salt. But being the perennial optimist whom I said earlier that I am, I tend to think that this convergence process is going to continue and there will be more and more uniformity looking forward. So far as that turns out to be the case. . .

Helper: Bob, can I have some of that stuff you're drinking?

Hockett: It's Kool-Aid. So that's the first point – so far as convergence happens (I can imagine a bumper sticker on that), who the regulator is doesn't make as much of a difference. The second point, which may be a slight, but only slight overstatement, is that when a particular financial institution is headquartered or primarily located in one jurisdiction but has significant operations in another jurisdiction, it is never the case that that other jurisdiction is somehow prevented or prohibited from regulating within its territorial borders in the interest of protecting various parties who might stand to be harmed by the operations of that institution. So, for example, if a Chinese bank tries to operate here in the U.S., I don't think that the Americans have to run and say, "Oh my God," or text, "OMG," then cry "these under-regulated Chinese banks are coming to America and we're all headed to Hell in a hand-cart!" My bet is that the Chinese banks would tell you that they beg to differ, because of course they have to deal with the U.S. regulators just as surely as the U.S. financial institutions must. So in that sense, I think that the kind of alarm that is sometimes sounded about overreliance on the regulatory power of the regulator in the

jurisdiction where the financial institution in question is headquartered is overstated.

Broome: Michael, you obviously have a different opinion on that. From an operational perspective, has Citi ever found itself at a disadvantage in competition in foreign countries with entities that are subject to a different home state regulator than the U.S.?

Helfer: Not so much that it interferes with our basic business model. But certainly sometimes we're at a competitive disadvantage because of U.S. rules. So looking forward, depending on how the Volker Rule comes out with respect to sovereign debt, we may be at a competitive disadvantage because of U.S. rules. We may be at a competitive disadvantage on Basel III because home country regulators will interpret risk weights in a way that effectively requires us to hold more capital. Sometimes it is the application of what the U.S. regulators do; sometimes it's the result of what the domestic regulator does. There are limits on branching and establishment of new banks in various countries that are applicable to foreign banks, including Citi, that limit their ability to compete in those countries. These limits may be to promote the domestic banking system or for other reasons. Sometimes U.S. institutions are put at a competitive disadvantage because of something the U.S. government does with respect to applications by banks from the host country to operate in the United States. Then there is retaliatory action, which is usually in the form of delay or non-action on applications. Sometimes, although it is unusual, non-banking related political or financial disputes involving the United States government can lead local host countries to take action or to decline to take action, the effect of which is to put us at a competitive disadvantage. So the answer is yes. It does not fundamentally affect the business model, but it happens often enough that it is something that we deal with on a regular basis.

Broome: Cyrus, how does the U.S. regulatory structure try to level this playing field for institutions that are subject to U.S. law?

Amir-Mokri: One way is a commitment to international

standards. Michael Helfer is right, international standards don't answer every question. There are going to be peculiarities of national law that have no relationship to the subject matter of the standards. Nevertheless, hopefully the standards are covering a lot of major issues that financial institutions have to deal with.

For the second way, let's distinguish between the activities of U.S. institutions outside the United States and the activities in the United States. Outside the United States, international standards are very important. In the United States, international standards are very important, but if there is a non-U.S. financial institution operating in the U.S., making sure that the relevant laws are not discriminatory but applied equally, both at the regulatory level and at the enforcement level, is also important so that everyone has the confidence that they're playing by the same set of rules.

I want to make one other point. I think regulators and law makers and people in government have to be very sensitive to the kinds of points that Michael Helfer just made about how domestic regulation of financial institutions or the bank holding company at home and some of the requirements that may get imposed on them have consequences for their behavior abroad. Just as we have to be sensitive to that we have to understand that there's a flipside to it and what we try to do, at least from the government's perspective, is to come up with a set of rules, regulations, laws that build confidence in our financial institutions. So one person's activity restriction or other kind of regulation is going to be another person's viewing that as a measure to not only give confidence to investors, but also counterparties, and also to raise the integrity of what we do. So sometimes we have to think hard about the consequences. But there is a lot to be said about the integrity of business done by U.S. institutions outside the United States. By integrity I don't mean fraud or something like that. I'm talking about dealing with others in a way that gives confidence that this institution is one I can deal with. If I put my money there, I'll be able to get it back and the terms of the deal are going to be the terms of the deal and so on. I think those are things that hopefully are not only not going to disadvantage our institutions, but actually going give them a leg up and give the brands that the U.S. has a different meaning to anyone who wants to do business with them abroad.

Broome: Nick, what's, what's your perspective on all this?

O'Neill: On a practical, day-to-day level since the financial crisis, I do not see regulators rushing to seize any control over the operations in their jurisdictions of entities that have a different home state. To a certain extent the trend is going in exactly the opposite direction. As the Basel standards and the other international standards become more embedded over time there's a greater level of confidence by the major international regulators when they are dealing with an entity that is branching into their jurisdiction, and which has a home state in one of those jurisdictions that has properly embedded those international standards. But since 2008, and perhaps I'm looking at it particularly from a U.K. and EU context, there is a greater level of nervousness about significant operations operating in a jurisdiction where the local regulator does not have ultimate regulatory control. You saw that particularly in the U.K. because its financial center has so many entities coming in whose home state is elsewhere. I think that led to a greater push for living wills, including as applied to branches, and for local subsidiarization. Not just in things like Vickers and other proposals, but actually in practical terms where we've seen some regulators say, "Look, this operation in our jurisdiction is just too big, we don't really, fully understand how it relates to the home state, we want some greater degree of control." Meanwhile, though we have also seen more of a "college" approach to regulation of some major international institutions – something that seems to have worked well. Maybe this will grow over time. Practically, what this means is that you have an entity which has major operations in two or three large financial centers where the regulators get together and cooperate to a greater extent, not necessarily in a formal role-sharing/authority-sharing sense, but in the sense of meeting together in some informal sense and swapping notes and discussing priorities. I think that is a potentially positive way forward. But I don't see a regulator ceding control to home states on an international basis, not totally – or at least not for the foreseeable future.

Broome: Chris, do you have any last words on this segment?

Brummer: Last words? Using the words “last words” and “financial regulation” is always dangerous.

I think when one considers international regulation, we should bear in mind that regulators are people and people make mistakes. The international standards are themselves the result of negotiation and a compromise. Then there are local differences. If one looks at other jurisdictions, there are some in which one could argue that the United States has a competitive advantage with regard to its rules and regulations. There are some jurisdictions that we have seen in Europe, including the United Kingdom, that have been very enthusiastic about “over-complying” with Basel III. The issue of gold plating is a big deal if you’re going to Switzerland, or if you’re even Sweden. So if those countries, for example, are deciding to go further than the United States, what specifically does that mean for our competitive advantages or disadvantages? Who is the weakest link?

I think that it’s important to get back to one original idea—an observation about transparency of the international regulatory system. The international standard setting process has generally not been the focus of enough political interest, or for that matter, there’s not been an institutional apparatus behind the international standard setting process sufficient to identify the level to which different jurisdictions, including the United States, complied with, or did not comply with any international standard. I’m not going to go into the depth as to the monitoring process associated with the IMF and the World Bank, but generally speaking unless you were a client state of the IMF or the World Bank, you didn’t necessarily have to undergo any kind of surveillance as to the degree to which you’re complying. There was an earlier remark about the EU, for example, not complying with some important aspects of Basel III.

To a certain degree, a securities law surveillance framework is necessarily imported to an international banking world. The degree to which disclosure becomes important—disclosure as to what a financial product is—is as much a product of a legal environment as it is of a specific trading environment. Understanding who your counterparty is and whether or not they are adequately capitalized in order to enter into certain kinds of transactions is an important consideration for financial

institutions. So at the international level there is, to a certain degree, a hope that the markets themselves can help with discipline. That ultimately by helping to identify, let's say, jurisdictions that are not complying with Basel III, or under-complying with Basel III, market discipline can ensure that financial institutions are going to have higher costs of capital or be subject to certain kinds of problems when they're trying to look for counterparties for certain kinds of transactions. Thus international standards in themselves can provide a benchmark of sorts for the market, and can be viewed as a tool for empowering investors and different kinds of market participants.

I think that the question of who regulates what doesn't get you to the deeper issue that there needs to be a lot of cooperation. Jurisdictions have different historical backgrounds, different traditions, and different institutional frameworks that are going to necessarily lead to varying levels of implementation. The question is whether or not jurisdictions can have enough faith and trust in one another to provide a means by which you, on the one hand, provide robust supervision and regulation, but at the same time, you minimize some of the inefficiencies that one sees with cross-border transactions.

A tool that has not been of enormous use, but will have to be at some point of increasing use, will be thinking through what kinds of mutual recognition programs can be in place between leading financial centers, and to use that process. Some people say that is just deregulatory. But, as a securities lawyer, if you look at the MJDS²⁰ and Canadian disclosures with regards to selling their securities in the United States and vice-versa, sometimes it's a glide path to fewer rules and fewer regulations. But, at the same time, where certain gaps are identified, the different participants in the regulatory framework can indeed raise standards and incentivize partners to raise standards. The point is that going forward, as we get to the implementation process, there will inevitably be pressure to identify the degree of acceptability of the departures from the international standard setting process. I think that regulators and their market participants all have to understand the inevitability ultimately of that process.

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V. THE APPROPRIATE BALANCE BETWEEN DOMESTIC REGULATION AND
GLOBAL FINANCIAL REGULATION

Helfer: Let me start with Cyrus. The question is whether it makes sense to devise different regulatory structures for wholly domestic institutions, from those institutions that operate cross-border. And, if it does make sense, what do you believe is the likelihood of that happening?

Amir-Mokri: I don't know that I would say wholly different. I mean, I think it will depend on the nature of the activity that you are regulating and the nature of the institution. To take a very simple example, suppose a broker-dealer has a purely domestic presence (that's hard to imagine) and then a broker-dealer has an international, or a cross-border activity. I would not necessarily apply different rules for the same activity. But, as I said earlier and as others have commented, different jurisdictions have particular traditions. I think institutions sometimes engage in purely local activities. There could be a justification that those kinds of activities that are particular or peculiar to a jurisdiction should be regulated differently. But to me the analysis really centers around what is the activity you are regulating? What are the entities you are regulating? That's how I would start the analysis.

Hockett: My own tendency is to think that the more important distinction is between systemically important and non-systemically important institutions. Naturally enough, I suppose, the systemically-important institutions are going, by their very nature, to be more often than not cross-border in their operations. But that is just a general tendency. I can certainly imagine that, on a case-by-case basis, there might sometimes be particular kinds of activity associated with cross-border transacting that is not associated with domestic transactions. In that case, it would make sense to regulate differently. But in the abstract, without any reference to particular transactions, it is kind of hard to say much more than that. So in this sense I would go right along with Cyrus.

VI. CONCLUDING REMARKS

The discussion concluded and Professor Lissa Broome thanked the panelists for their comments and the audience for its attention. She invited all to a reception for continued conversation.